
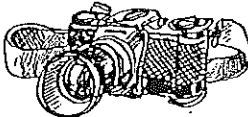


The Theory of Comparative Advantage

In Japan, it costs 1000 yen to produce a bottle of whisky: in Britain it costs £2. In Japan it costs 8000 yen to produce a simple camera: in Britain, it costs £20. This can be summarised like this:

| Cost of Production | | |
|--------------------|---|--|
| |  |  |
| JAPAN | 1000yen | 8000yen |
| U.K. | £2 | £20 |

STUDY POINTS

- What is the opportunity cost of producing 1 camera in Japan i.e. how many bottles of whisky could have been produced for the same cost as one camera?
- What is the opportunity cost of producing 1 camera in the UK?
- Which country can produce whisky more cheaply (relative to cameras)?
- Which country can produce cameras more cheaply (relative to whisky)?
- Each year, the Japanese buy 8 million bottles of whisky and 1 million cameras. How much in total would it cost the Japanese if all cameras and all whisky were produced in Japan?
- Each year, the British buy 20 million bottles of whisky and 1 million cameras. How much in total would it cost the British if all cameras and all whisky were produced in the UK? Japan and the UK decide to trade whisky for cameras at an exchange rate of 1 camera for 9 bottles of whisky.
- How many cameras can Japan make instead of the 8 million bottles of whisky she produces?
- How many cameras will she now produce if she also carries on producing the 1 million cameras as before?
- How many bottles of whisky can the UK now produce (including the 20 million bottles produced before) if she switches resources from the production of cameras to whisky?
- Japan offers to trade 1 million cameras for whisky with the UK. How much whisky can she obtain in exchange?
- How many cameras and how much whisky is now available for sale in Japan? Is Japan better or worse off than before trade took place?
- How many cameras and how much whisky is now available for sale in the UK? Is the UK better or worse off than before trade took place?

'Italy sold 28 million pairs of leather shoes to Britain in 1983 at an average price per pair of £6. So it might come as a surprise to learn that Britain managed to sell 321 000 pairs to the Italians at an average price of £12 per pair, and it's a quality which appears to be the characteristic which captures the Italians to buy British.' (Source: The Guardian, 4 June 1985)

Why should Italians buy British shoes when Italy is one of the world's leading producers of shoes? Why is Italy a more important producer of shoes than Britain anyway?

Specialisation

To answer these questions, we need to develop the theory of specialisation. Specialisation, discussed in Unit 7, means that producers specialise in producing products or performing tasks. One example of specialisation is the division of labour. If specialisation is to make economic sense, producers must specialise in what they are best at producing.

Figure 73.1 gives some sample figures for the production of shoes in the UK and in Italy. For the sake of argument, assume that Italy and the UK only produce shoes and that the only cost of production is labour. It can be seen from the table that Italy is better at producing ordinary shoes than the UK because it costs only 20 man-hours to produce a pair of ordinary shoes in Italy, but 200 man-hours in the UK. Italy is said to have an **ABSOLUTE ADVANTAGE** in the production of ordinary shoes. On the other hand, the UK has an **absolute advantage** in the production of quality shoes – i.e. the UK is better at producing quality shoes than Italy. It would make sense for Italy to produce ordinary shoes and exchange them for quality shoes made in the UK.

But what would happen if Italy